NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

March 13, 2012

Technical Director
File Reference No. 2011-220
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Submitted via electronic mail to director@fasb.org

Re: File Reference No. 2011-230, *Revenue from Contracts with Customers*

Dear Sir/Madam:

This letter is submitted in response to the request for public comment by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) with respect to the Proposed Accounting Standards Update (Revised) on *Revenue Recognition (Topic 605): Revenue from Contracts with Customers* (the Revised Proposed Update).

NAREIT is submitting these comments on behalf of the following member organizations of the Real Estate Equity Securitization Alliance (REESA):

- Asia Pacific Real Estate Association, APREA
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts (United States), NAREIT
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

The purpose and activities of REESA are discussed in Appendix I. Members of the organizations identified above would be pleased to meet with the Boards or staff to discuss any questions regarding our comments on the Revised Proposed Update.

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We thank the Boards for the opportunity to provide further input on the *Revenue from Contracts with Customers* proposal. If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432, or Christopher Drula, NAREIT's Senior Director, Financial Standards, at 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Senior Director, Financial Standards

Comment Letter Submitted by the

National Association of Real Estate Investment Trusts (United States), NAREIT

On behalf of the following members of the
Real Estate Equity Securitization Alliance (REESA):

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Real Property Association of Canada, REALpac

In response to the

Proposed Accounting Standards Update (Revised)—*Revenue Recognition (Topic 605): Revenue from Contracts with Customers*

Issued by the

Financial Accounting Standards Board and
International Accounting Standards Board

on November 14, 2011

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Dear Sir/Madam:

The Real Estate Equity Securitization Alliance is a global coalition of representative real estate organizations from around the world. REESA seeks to help promote equity investment in real estate on a securitized basis. Together, the members of REESA represent the vast majority of constituent companies in the FTSE EPRA/NAREIT Global Real Estate Index. REESA focuses on cross-border investment, international taxation, financial reporting standards initiatives, and educational outreach to investors. REESA members represent major operating real estate companies (including REITs) – companies that acquire, develop, lease, manage and opportunistically sell investment property.

REESA Has Consistently Supported the Convergence Process

For many years, REESA has supported the Boards' efforts to achieve convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). One of REESA's primary goals is to achieve uniform financial reporting by our member companies. REESA has achieved significant consensus on over a dozen accounting standards proposed by the FASB and the IASB and has submitted comment letters that reflect the global consensus.

REESA has been fully engaged in the Boards' discussions on major convergence projects and have actively participated in meetings with the Boards and their staff with respect to these projects. REESA greatly appreciates the opportunities to express our global views through these meetings and comment letters.

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REESA has provided input to the Board with respect to the Revenue Recognition Project for over three years.

On June 19, 2009, REESA submitted a comment letter in response to the Boards' Discussion Paper, *Preliminary Views on Revenue from Contracts with Customers*.

On April 28, 2010, NAREIT and REALpac provided an education session to members of the FASB and the FASB staff on applying the proposed revenue recognition guidance to real estate transactions.

On October 20, 2010, REESA submitted a comment letter in response to the Boards' Exposure Draft, *Revenue from Contracts with Customers.*

On May 3, 2011 and May 13, 2011, NAREIT participated in the FASB's Emerging Issues Task Force (EITF) Working Group on Issue 10-E, *Derecognition of in Substance Real Estate – A Scope Clarification.*

On November 29, 2011, NAREIT participated in a roundtable meeting with members of the FASB and the FASB staff on potential effects of the Revised Proposed Update on real estate transactions.

Overview

Consistent with our support for the development of high-quality global accounting standards, REESA applauds the Boards for developing a converged proposal on revenue recognition. We acknowledge the significant challenges involved in standard-setting, and we value the Boards' dedication to delivering high-quality global solutions.

REESA supports the general framework of the revenue recognition proposal. In addition, REESA believes that the Revised Proposed Update would generally improve financial reporting by more faithfully reflecting the substance of real estate sales transactions in the financial statements. However, we do have several specific concerns with the Revised Proposed Update, which are addressed below.

<u>The Revised Proposed Update should apply to *All* Sales of Real Estate</u>

REESA reiterates its support for applying the Revised Proposed Update to *all* sales of real estate; not only those sales representing outputs of an entity's ordinary activities.

This is not a new issue for us. In conjunction with an education session in 2010 with members of the FASB, NAREIT and REALpac representatives expressed to the Board that their primary concern with the proposed accounting model was that it would not be the same for *all* sales of real estate. This is especially important to us because the real estate industry operates with a significant amount of "in substance" real estate sales. While we understand that the Boards'

intend to make consequential amendments to other IFRS/U.S. GAAP so that transactions involving non-financial assets that do not represent outputs of an entity's ordinary activities would be treated in a manner similar to the Revised Proposed Update, we remain seriously concerned about the treatment of sales of equity interests that represent "in-substance" real estate. As stated in our comment letter of October 20, 2010, we believe that the revenue recognition principles in the Revised Proposed Update should apply to *all* sales of real estate, including equity interests in entities that represent "in substance" real estate. Therefore, we request that the Boards expand the scope of the Revised Proposed Update to include *all* sales of real estate and investments in entities that represent "in substance" real estate. By addressing REESA's concern in expanding the scope of the Revised Proposed Update, the Boards would ensure that identical transactions, despite whether or not they represent outputs of an entity's ordinary activities, would result in similar accounting.

Remain true to the underlying Concept of Control

REESA agrees with the Revised Proposed Update's overarching principle that revenue would be recognized when control transfers to the customer. Additionally, REESA supports the Boards' approach in identifying indicators that control has been transferred from the seller to the purchaser. Overall, REESA welcomes the principles-based approach that the Boards have developed, and fully supports the removal of the bright-line, rule-based, approach to accounting for sales of real estate that currently exists in FASB ASC Topic 360 (formerly FAS 66, *Accounting for Sales of Real Estate*).

REESA has consistently supported the Boards' guidance on protective rights, an issue that we have raised in both our 2009 and 2010 comment letters. Specifically, we have agreed that the absence of legal transfer of title to real estate sold would not preclude revenue recognition assuming the transfer of control, if the seller retains title to secure payment. REESA would apply this guidance to anti-speculation clauses (*e.g.,* clauses that require the buyer to develop land in a specific manner or within a stated period of time) and other protective rights commonly included in real estate sales contracts giving sellers the right to reacquire the property upon noncompliance by the buyer.

REESA observes that the FASB has recognized the potential conflict between recently issued accounting guidance and the Revised Proposed Update. In December 2011, the FASB issued Accounting Standards Update No. 2011-10*, Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate – A Scope Clarification (a consensus of the FASB Emerging Issues Task Force)* (ASU 2011-10). The main provisions of ASU 2011-10 are as follows:

> [W]hen a parent (reporting entity) ceases to have a controlling financial interest (as described in Subtopic 810-10) in a subsidiary that is in substance real estate as a result of default on the subsidiary's non-recourse debt, the reporting entity should apply the guidance in Subtopic 360-20 to determine whether it should derecognize the in substance real estate. Generally, a reporting entity would not satisfy the requirements to

> derecognize the in substance real estate before the legal transfer of the real estate to the lender and the extinguishment of the related non-recourse indebtedness. That is, even if the reporting entity ceases to have a controlling financial interest under Subtopic 810-10, the reporting entity would continue to include the real estate, debt, and the results of the subsidiary's operations in its consolidated financial statements until legal title to the real estate is transferred to legally satisfy the debt[1].

REESA raised the apparent contradiction in accounting guidance in conjunction with the EITF Working Group that focused on Issue 10-E, *Derecognition of in Substance Real Estate – A Scope Clarification.* Unfortunately, the FASB dismissed a control-based assessment for these transactions, and moved forward with issuing the rule-based guidance included in ASU 2011-10.

At this critical juncture, REESA recommends that the FASB and IASB:

- Address our original concerns and revisit this inconsistency jointly;
- Remain true to the Boards' principles-based approach to revenue recognition that is based on the notion of control as opposed to a rule-based standard that includes a "bright-line"; and,
- Rescind the recently issued ASU 2011-10 in its entirety.

By following REESA's recommendation, the Boards would address our concerns with respect to the apparent inconsistency between the rule-based accounting approach contained in existing U.S. GAAP and the Revised Proposed Update.

<u>Account for Leases with Embedded Services as One Lease Contract</u>

Over time, lease agreements have evolved from strictly payment for the rental of space (*i.e.,* a net lease) with separate charges for items like common area maintenance (CAM) to leases where the rent payment includes the reimbursement for embedded services (*i.e.,* a gross lease) . Examples of embedded services in lease agreements include:

- CAM;
- Security;
- Taxes and Insurance; and,
- Landscaping.

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[1] http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823567681&blobheader=application%2Fpdf

REESA observes that these services are performed by the lessor to protect its own interests, instead of for the benefit of the lessee. The lessor performs these services in large part to maintain the quality, ongoing appeal, and value of the lessor's underlying asset. Therefore, REESA does not believe that these services should be separated from the rental revenue stream. As a result, these items should be subject to the Leases exposure draft, and be outside the scope of the Revised Proposed Update.

Align Inconsistent Revenue Recognition Models

Through its review of various accounting standards during the convergence process, REESA has observed inconsistencies in the revenue recognition patterns for lease contracts with embedded services in the following accounting literature:

- International Accounting Standard 40, *Investment Property*;
- FASB Proposed Accounting Standards Update *Investment Property Entities*;
- IFRS Exposure Draft ED/2010/9 *Leases*;
- FASB Proposed Accounting Standards Update *Leases (Topic 840)*; and,
- The Revised Proposed Update.

Today, the unit of account for a gross lease that contains embedded services is the lease contract with no bifurcation for embedded services. The accounting guidance in IAS 40, and in the FASB's Investment Property Entities exposure draft, as well as in both of the current forms of Leases accounting guidance under U.S. GAAP and IFRS, do not require the bifurcation of embedded services from rental payments. This is due to the fact that the lease agreement containing embedded services is negotiated as a single contract with one single rental payment.

The interaction between the Leases exposure draft and the Revised Proposed Update appears to significantly change the unit of account for the same lease agreement.

We understand that the current guidance in the Revised Proposed Update would initially exclude lease contracts from its scope. However, the Leases exposure draft would require a preparer to separate distinct services from the lease contract, and account for those distinct services as separate performance obligations in accordance with the Revised Proposed Update.

The result would be reporting an amount for service revenue (which is not negotiated separately and would represent a guesstimate at best) separate and apart from gross rental revenue (which is supported directly by the lease contract). Additionally, companies would be required to comply with the disclosure guidance in the Revised Proposed Update that includes separate roll forwards for each performance obligation. REESA believes that such disclosures would be inoperable, and given the amount of estimation involved, of little use to investors and users of financial

statements. Lessors would be reporting amounts based on thousands of estimates rather than the gross rental payment in the lease.

Based on an informal survey of a number of our member companies, the total number of separate services for one member could reach as many as 960,000 separate performance obligations given the company's large portfolios of leases and number of services performed under these leases. REESA questions if this was the intention of the FASB and IASB when they collectively drafted the Revised Proposed Update. In our view, the proposed model is unworkable, further complicates financial reporting, and will result in confusion amongst users, investors, preparers and auditors alike. Further, the costs to implement the standard for embedded services in lease agreements will far outweigh the perceived benefits.

REESA recommends that the Boards revisit the criteria to determine whether a service is distinct. In our view, the unit of account for a lease agreement should be the entire lease contract and rental income should reflect amounts supported by the lease contract. This would be consistent with how the guidance included in IAS 40 is currently applied in more than 100 countries throughout the world.

Provide further Clarification for Sales of Real Estate Involving Put and Call Options

The guidance with respect to sales of real estate with put and call options requires further clarification. REESA observes that transactions including put and call options are becoming increasingly prevalent in the real estate industry today.

The Revised Proposed Update provides application guidance on accounting for unconditional put options; however, for a majority of real estate sales, put options are often *conditional*. For example, a put option may be exercised if completion of a building is not to specification, within an agreed-upon timeframe, or certain pre-leasing thresholds are not met. There is no specific guidance within the Revised Proposed Update to assist in determining revenue recognition in contracts which include *conditional* put options. As a result, it is unclear as to whether put options subject to conditions should be accounted for using application guidance paragraphs B2 – B9 (Sale with a right to return), B38 – B48 (Repurchase Agreements) or B55 – B58 (Customer Acceptance).

Depending on the application guidance applied, the accounting treatment may vary considerably. In particular, if the Repurchase Agreements guidance is applied it is likely that a majority of Real Estate transactions involving a put option will recognize revenue on contract execution. Whereas if the Sale with a Right to Return or Customer Acceptance guidance is applied, the recognition of revenue is more likely to be deferred, possibly until lapse of the put option.

Further, it is unclear as to how to account for put options with an exercise price at fair value and transactions where the vendor and purchaser simultaneously enter into a put and call option to facilitate the future settlement of a property.

We recommend that the Boards further explore the current guidance and consider including additional illustrative examples in their revised guidance.

Expand guidance on Determining whether an Asset has an Alternative Use to an Entity

REESA welcomes the Boards' efforts to address the challenging issue of revenue recognition for what some refer to as "off the plan" sales, as outlined in Example 7. However, the example raises questions for the real estate sector that may have significant impact on how revenue is recognized, in particular whether the Revised ED opens progressive revenue recognition to a majority of "off the plan" development transactions.

The example suggests progressive revenue recognition for a wider range of contracts compared to the current standard. However, there are some aspects that are unclear and could potentially lead to inconsistencies in application.

The example provided in the Revised Proposed Update is a significant step away from existing IFRS guidance and appears to allow revenue recognition where the customer promises to make payments to the developer throughout the construction period. The significance of timing and receipt of these promised payments may be interpreted differently. It is also not clear how differences in certain jurisdictions would affect revenue recognition under the Revised Proposed Update. For example, in some jurisdictions, payments for off-the-plan sales are made progressively throughout the construction period; whereas, in other jurisdictions, commercial practice would involve an upfront deposit, generally around 10 percent of the total purchase price, with the remainder paid on settlement, being when construction is complete. Currently under existing IFRS guidance, revenue recognition under the second scenario is not permitted; rather, revenue would be recognized on completion/settlement.

The example allows progressive revenue recognition even where there is a right to refund for non-performance. Clarity is required in order to support consistent application, in particular around requirements in situations where the original developer is unable to complete the development (*e.g.,* in case of an insolvency). In such a situation, some of the factors that will have an implication on the pattern of revenue recognition include but are not limited to:

- The ownership of the work-in-progress and who bears the risk of an incomplete project; and,

- The manner in which the contract with the customer will unwind and customer compensation.

REESA observes that the Revised Proposed Update does not provide sufficient guidance with respect to these situations. Therefore, REESA recommends that the Boards expand the example to address the instances identified above.

Disclosure requirements

In our view, some of the disclosure requirements included in the Revised Proposed Update are excessive and unduly complex. Our key observations are as follows:

Disaggregation of revenue

In our view, the segment reporting currently provided by public companies, which is consistent with the information provided to the chief operating decision maker, provides adequate guidance to users of the accounts. We also consider the additional disclosure requirements to be excessive for private companies that are not currently required to provide segmental disclosures.

In addition, the range of disaggregation options provided in the Revised Proposed Update is likely to lead to inconsistent disclosure across the real estate industry.

We recommend that the Board refine and clarify the disclosure requirements.

Performance obligations

In our view, we believe that the disclosure requirements for individual performance obligations in paragraph 119 would result in the disclosure of sensitive proprietary information. Therefore, we urge the Boards to clarify that this information may be aggregated for all performance obligations as opposed to individual performance obligations.

Significant judgments in the application of the Revised Proposed Update

In our view, it is impractical to disclose information surrounding judgments and changes in judgments on application of the revised standard. We consider the current disclosure requirements contained in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to be adequate.

We recommend that the Boards remove this disclosure requirement.

Conclusion

In summary, we recommend that the Boards address our concerns by making the following revisions to the Revised Proposed Update before issuing it as a final standard:

- Expand the scope of the Revised Proposed Update to include *all* sales of real estate and investments in entities that represent "in substance" real estate to ensure that identical transactions, whether or not they represent outputs of an entity's ordinary activities, would result in similar accounting.

- Remain true to the Boards' principles-based approach to revenue recognition that is based on the notion of control as opposed to a rule-based standard that includes a "bright-line"; and, rescind the recently issued FASB ASU 2011-10 in its entirety.

- Clarify that services performed by the lessor to protect its own interests instead of for the benefit of the lessee, to maintain the quality, ongoing appeal, and value of the lessor's underlying asset are outside the scope of the Revised Proposed Update.

- Revise the criteria to determine whether a service is distinct to ensure that services that are jointly negotiated with the lease contract are accounted for as one contract, *i.e.,* the lease contract, and are therefore clearly outside the scope of the Revised Proposed Update.

- Further explore appropriate guidance on sales involving put and call options, and consider including additional illustrative examples on this matter in the Revised Proposed Update.

- Expand the illustrative example on determining whether an asset has an alternative use to an entity.

- Simplify disclosure requirements on disaggregation of revenue, performance obligations, and significant judgments in the Revised Proposed Update.

We appreciate the opportunity to share our views with the FASB and IASB and welcome the Boards' questions on our comments.

Respectfully submitted,

Asia Pacific Real Estate Association

British Property Federation

European Public Real Estate Association

National Association of Real Estate Investment Trusts (United States)

Property Council of Australia

Real Property Association of Canada

Appendix I

REESA – The Real Estate Equity Securitization Alliance

REESA is made up of seven real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The REESA member organizations are:

- Asia Pacific Real Estate Association, APREA
- Association for Real Estate Securitization in Japan, ARES
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts, NAREIT®
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

REESA has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards.

Since its formation REESA members have exchanged views on a number of accounting and tax related projects and shared these views with regulators and standards setters. These projects include:

- FASB Investment Companies
- FASB Investment Property Entities
- IASB Investment Entities
- FASB Consolidation: Principle versus Agent Analysis
- IASB Agenda Consultation 2011
- FASB/IASB Lease Accounting
- FASB/IASB Financial Statement Presentation
- FASB/IASB Reporting Discontinued Operations
- FASB/IASB Revenue from Contracts with Customers
- FASB/IASB Effective Dates and Transition Methods
- IASB Fair Value Measurement
- IASB Income Tax
- IASB Real Estate Sales – IFRIC D21

- IASB Capitalization of Borrowing Costs – IAS 23
- IASB Accounting for Joint Arrangements – ED 9
- IASB Consolidated Financial Statements – ED 10
- IASB 2007/2008/2009 Annual Improvements to IFRS
- OECD developments on cross border real estate flows and international tax treaties